

Hon. Stephen L. Johnson
Administrator
United States Environmental Protection Agency
1200 Pennsylvania Avenue, NW
Washington, DC 20460

Dear Administrator Johnson:

The Environmental Financial Advisory Board is pleased to submit the enclosed report, "Expanding the Definition of SRF Financial Assistance" for the Agency's consideration and use. This report supports authorizing SRFs to provide a form of financial assistance to eligible projects that would not require that invested program equity be yield restricted under IRS arbitrage regulations. Without the restrictions, SRF programs could earn more interest and use that money for projects. The perpetuity requirement applicable to SRFs would remain unchanged.

Under EPA's current SRF regulations, a subsidy can be given to a borrower in order to provide a below market interest rate on a loan either made or local debt obligation purchased by the SRF. However, the use of SRF equity to provide a debt service subsidy triggers the federal arbitrage restrictions on the investment of SRF program equity. Efforts to obtain relief from the arbitrage regulations by exempting SRFs from application of the generally applicable arbitrage rules have not been successful thus far.

The proposed alternative is to permit SRF assistance to eligible projects for capital or operating costs. Project eligibility would be determined under the same set of rules as presently exist, so that the kinds of projects eligible for assistance would not change under this new program. For example, an SRF could provide assistance (in an amount equivalent to what would currently be provided as a debt service subsidy) either by funding construction costs or funding an annual operating subsidy for a project that receives a market rate SRF financing. The SRF would still have to be maintained in perpetuity. The effect of the perpetuity requirement is that whatever the form of the financial assistance (i.e., for debt service, capital or operating cost of an eligible project), it would have to be provided from accumulated, current or future earnings on SRF equity.

By combining a guaranty of borrower debt (or a market rate loan from the SRF to the borrower or a purchased local debt obligation) with the provision of capital or operating assistance, there would be no basis under the arbitrage regulations for any yield restriction of SRF money relating to the provision of that assistance. While the Department of the Treasury may have some concerns with this approach, we believe this idea derived from a guaranty approach, creates the possibility of realizing the benefit of arbitrage relief without the need to change existing IRS regulations.

Rather than requiring a change in or exception to IRS regulations, this approach allows SRF assistance to be structured in a way that does not trigger the application of the IRS arbitrage rules. Amendments to Clean Water SRF and Drinking Water SRF regulations that could be made to implement this concept (with complementary statutory authority) are offered in this paper.

No significant change in the administration or supervision of the state SRFs would be required under this approach. Also, this would not change the SRF program into a traditional “grant” program since the SRF would still be maintained in perpetuity. However, small communities, in particular, that may have previously been reluctant to take advantage of the SRF program because of lack of understanding of the benefits of reduced interest rates may be attracted to the idea of operating subsidies (even though the net financial impact would be the same). Thus, this programmatic change may have the collateral benefit of attracting new participants to the SRF program. This would be especially beneficial because a community that participates in the SRF program is subject to conditions that move the community toward improved financial management and full-cost pricing.

The Board appreciates the continuing opportunity to provide financial advisory assistance to the Agency on issues of national importance.

Sincerely,

A. James Barnes
Chair

A. Stanley Meiburg
Executive Director

Enclosure

cc: Ben Grumbles, Assistant Administrator for Water
Lyons Gray, Chief Financial Officer